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Internal Assesment Test - I

Sub:	Financial Management							Code:	16MBA22
Date:	27.03.17	Duration:	90 mins	Max Marks:	40	Sem:		Branch:	MBA
Answer Any THREE FULL Questions (10*3=30 Marks)									

			Marks	OBE CO	OBE RBT
Part A 02 full question					
1	(a)	What is present value? How do you arrive at discount factor?. Present value is the current value of a future amount. The amount to be invested today at a given interest rate over period to equal the future amount. Its the procedure to finding the present value approach future sums are converted into present value commonly called Discounting.	[02]	CO1	L1
	(b)	Define the Cost of Capital. Explain the significance of cost of capital in Financial Management. Cost of capital is the rate of return that the firm must earn on its project/ investment to maintain its market value and attract funds. The cost concept is * Rate of return, * Minimum rate of return , * cost of capital. Significance of cost of capital: 1. Designing Optimal Capital Structure: Capital Structure involues determination of proportion of debt and equity in capital structure where cost of capital is minimum. While designing a firms capital structure financial executives always keep in mind minimization of overall cost of capital. 2. Capital budgeting Evaluation: Depending on the business, the competitive environment and industry forces, companies will certainly have some unique desirability criteria. As noted earlier, it's very crucial to remember that the capital budgeting process involves two sets of decisions, investment decisions and financial decisions; given the unique business and market environments that exist at the time, each decision may not initially be seen as worthwhile individually, but could be worthwhile if both were to be undertaken. 3. Financial performance Appraisal: Financial performance analysis includes analysis and interpretation of financial statements in such a way that it undertakes full diagnosis of the profitability and financial soundness of the business. The financial analyst program provides vital methodologies of financial analysis. Areas of Financial Performance Analysis:	[06]	CO1	L1

Financial analysts often assess the firm's production and productivity performance (total business performance), profitability performance, liquidity performance, working capital performance, fixed assets performance, fund flow performance and social performance. Various financial ratios analysis includes

1. Working capital Analysis
2. Financial structure Analysis
3. Activity Analysis
4. Profitability Analysis

(c) Describe the interrelation between Investment, Financing and Dividend decisions. [08] CO2 L2

Investment Decision

One of the most important finance functions is to intelligently allocate capital to long term assets. This activity is also known as capital budgeting. It is important to allocate capital in those long term assets so as to get maximum yield in future. Following are the two aspects of investment decision

a. Evaluation of new investment in terms of profitability
b. Comparison of cut off rate against new investment and prevailing investment.

Since the future is uncertain therefore there are difficulties in calculation of expected return. Along with uncertainty comes the risk factor which has to be taken into consideration. This risk factor plays a very significant role in calculating the expected return of the prospective investment. Therefore while considering investment proposal it is important to take into consideration both expected return and the risk involved.

Investment decision not only involves allocating capital to long term assets but also involves decisions of using funds which are obtained by selling those assets which become less profitable and less productive. It wise decisions to decompose depreciated assets which are not adding value and utilize those funds in securing other beneficial assets. An opportunity cost of capital needs to be calculating while dissolving such assets. The correct cut off rate is calculated by using this opportunity cost of the required rate of return (RRR)

Financial Decision

Financial decision is yet another important function which a financial manger must perform. It is important to make wise decisions about when, where and how should a business acquire funds. Funds can be acquired through many ways and channels. Broadly speaking a correct ratio of an equity and debt has to be maintained. This mix of equity capital and debt is known as a firm’s capital structure.

A firm tends to benefit most when the market value of a company’s share

maximizes this not only is a sign of growth for the firm but also maximizes shareholders wealth. On the other hand the use of debt affects the risk and return of a shareholder. It is more risky though it may increase the return on equity funds.

A sound financial structure is said to be one which aims at maximizing shareholders return with minimum risk. In such a scenario the market value of the firm will maximize and hence an optimum capital structure would be achieved. Other than equity and debt there are several other tools which are used in deciding a firm capital structure.

Dividend Decision

Earning profit or a positive return is a common aim of all the businesses. But the key function a financial manger performs in case of profitability is to decide whether to distribute all the profits to the shareholder or retain all the profits or distribute part of the profits to the shareholder and retain the other half in the business.

It's the financial manager's responsibility to decide a optimum dividend policy which maximizes the market value of the firm. Hence an optimum dividend payout ratio is calculated. It is a common practice to pay regular dividends in case of profitability Another way is to issue bonus shares to existing shareholders.

2 (a) An investor wants to find the present value of Rs 40000 due for 3 years. His interest rate is 10%. [02] CO2 L3

Pv= Fv3 {1/1+I}3
40000*(0.751)
30,040

(b) Discuss the cost of capital and classify the different methods of valuations. [06] CO3 L2

(c) Mr. Y deposited at the end of each year Rs 500, Rs 900, Rs 1400, Rs 2400 in the saving bank account for 5 years. Calculate his future value of series of deposits if the bank pay 5% compound rate of interest. [08] C03 L4

Year	Cash outflow	No of terms compounding	CF 5%	CV
1	500	4	1.261	608
2	900	3	1.191	1042.2
3	1400	2	1.121	1544.2
4	2400	1	1.060	2520

FV = 5714.4

3 (a) Why does time value of money exists? Give reason. [02] CO1 L1

The time value of money (TVM) is the idea that money available at the present time is worth more than the same amount in the future due to its potential earning capacity. This core principle of finance holds that, provided money can earn interest, any amount of money is worth more the sooner it is received. TVM is also referred to as present discounted value.

Money deposited in a savings account earns a certain interest rate. Rational investors prefer to receive money today rather than the same amount of money in the future because of money's potential to grow in value over a given period of time. Money earning an interest rate is said to be compounding in value.

(b) The details of dividend paid by cool ltd on its existing equity share of Rs 10each for the past 6 years is given below: [06] C04 L3

Year	2010	2011	2012	2013	2014	2015
DPS	1.05	1.10	1.16	1.21	1.27	1.34

The current market price of equity share is Rs 40. It is expected to maintain the fixed dividend ratio in the future. The company has issued new equity share of Rs 20 each and its flotation cost Rs 0.70 per share. The expected dividend to be declared for the current year is Rs 1.40. calculate cost of capital.

(c) Explain the sources of fund

There are various sources of finance such as equity, debt, debentures, retained earnings, term loans, working capital loans, letter of credit, euro issue, venture funding etc. These sources are useful in different situations. They are classified based on time period, ownership and control, and their source of generation. Sources of finance are the most explored area especially for the entrepreneurs about to start a new business. It is perhaps the toughest part of all the efforts. There are various sources of finance classified based on time period, ownership and control, and source of generation of finance.

Having known that there are many alternatives of finance or capital, a company can choose from. Choosing right source and the right mix of finance is a key challenge for every finance manager. The process of selecting right source of finance involves in-depth analysis of each and every source of finance. For analyzing and comparing the sources of finance, it is required to understand all characteristics of the financing sources. There are many characteristics on the

basis of which sources of finance are classified.

On the basis of a time period, sources are classified into long term, medium term, and short term. Ownership and control classify sources of finance into owned capital and borrowed capital. Internal sources and external sources are the two sources of generation of capital. All the sources of capital have different characteristics to suit different types of requirements. Let's understand them in a little depth.

ACCORDING TO TIME-PERIOD:

Sources of financing a business are classified based on the time period for which the money is required. Time period is commonly classified into following three:

LONG TERM SOURCES OF FINANCE

Long-term financing means capital requirements for a period of more than 5 years to 10, 15, 20 years or maybe more depending on other factors. Capital expenditures in fixed assets like plant and machinery, land and building etc of a business are funded using long-term sources of finance. Part of working capital which permanently stays with the business is also financed with long-term sources of finance. Long term financing sources can be in form of any of them:

- Share Capital or Equity Shares
- Preference Capital or Preference Shares
- Retained Earnings or Internal Accruals
- Debenture / Bonds
- Term Loans from Financial Institutes, Government, and Commercial Banks
- Venture Funding
- Asset Securitization
- International Financing by way of Euro Issue, Foreign Currency Loans, ADR, GDR etc.

MEDIUM TERM SOURCES OF FINANCE

Medium term financing means financing for a period of 3 to 5 years. Medium term financing is used generally for two reasons. One, when long-term capital is not available for the time being and second, when deferred revenue expenditures like advertisements are made which are to be written off over a period of 3 to 5 years. Medium term financing sources can in the form of one of them:

- Preference Capital or Preference Shares
- Debenture / Bonds
- Medium Term Loans from
  - Financial Institutes
  - Government, and
  - Commercial Banks
- Lease Finance
- Hire Purchase Finance

SHORT TERM SOURCES OF FINANCE

Short term financing means financing for a period of less than 1 year. Need for

short term finance arises to finance the current assets of a business like an inventory of raw material and finished goods, debtors, minimum cash and bank balance etc. Short term financing is also named as working capital financing. Short term finances are available in the form of:

- Trade Credit
- Short Term Loans like Working Capital Loans from Commercial Banks
- Fixed Deposits for a period of 1 year or less
- Advances received from customers
- Creditors
- Payables
- Factoring Services
- Bill Discounting etc.

ACCORDING TO OWNERSHIP AND CONTROL:

Sources of finances are classified based on ownership and control over the business. These two parameters are an important consideration while selecting a source of finance for the business. Whenever we bring in capital, there are two types of costs – one is interest and another is sharing of ownership and control. Some entrepreneurs may not like to dilute their ownership rights in the business and others may believe in sharing the risk.

OWNED CAPITAL

Owned capital is also referred as equity capital. It is sourced from promoters of the company or from the general public by issuing new equity shares. Business is started by the promoters by bringing in the required capital for a startup. Owners capital is sourced from following sources:

- Equity Capital
- Preference Capital
- Retained Earnings
- Convertible Debentures
- Venture Fund or Private Equity

Further, when the business grows and internal accruals like profits of the company are not enough to satisfy financing requirements, the promoters have a choice of selecting ownership capital or non-ownership capital. This decision is up to the promoters. Still, to discuss, certain advantages of equity capital are as follows:

- It is a long term capital which means it stays permanently with the business.
- There is no burden of paying interest or installments like borrowed capital. So, the risk of bankruptcy also reduces. Businesses in infancy stages prefer equity capital for this reason.

BORROWED CAPITAL

Borrowed capital is the capital arranged from outside sources. These include the following:

- Financial institutions,
- Commercial banks or
- The general public in case of debentures.

In this type of capital, the borrower has a charge on the assets of the business which means the borrower would be paid by selling the assets in case of liquidation. Another feature of borrowed capital is regular payment of fixed interest and repayment of capital. Certain advantages of borrowing capital are as follows:

- There is no dilution in ownership and control of business.
- The cost of borrowed funds is low since it is a deductible expense for taxation purpose which ends up saving on taxes for the company.
- It gives the business a leverage benefit.

ACCORDING TO SOURCE OF GENERATION:

INTERNAL SOURCES

Internal source of capital is the capital which is generated internally from the business. Internal sources are as follows:

- Retained profits
- Reduction or controlling of working capital
- Sale of assets etc.

The internal source has the same characteristics of owned capital. The best part of the internal sourcing of capital is that the business grows by itself and does not depend on outside parties. Disadvantages of both equity capital and debt capital are not present in this form of financing. Neither ownership is diluted nor fixed obligation / bankruptcy risk arises.

EXTERNAL SOURCES

An **e**xternal source of finance is the capital which is generated from outside the business. Apart from the internal sources finance, all the sources are external sources of capital.

Deciding the right source of finance is a crucial business decision taken by top-level finance managers. The wrong source of finance increases the cost of funds which in turn would have a direct impact on the feasibility of project under concern. Improper match of the type of capital with business requirements may go against the smooth functioning of the business. For instance, if fixed assets, which derive benefits after 2 years, are financed through short-term finances will create cash flow mismatch after one year and the manager will again have to look for finances and pay the fee for raising capital again.

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(8)

Part B Compulsory

6	In what way Wealth Maximization objective is superior than profit maximization objective? Explain.	[08]	C02	L3

Shareholder wealth maximization should be the basic goal of any corporation. The justification for this goal are as follows:

1. Wealth Maximization Objective Recognizes The Time Value Of Money
Time value of money is an important concept in financial decision making. Wealth maximization goal recognizes this concept. According to this concept, all cash flows generated over the life of the project are discounted back to present value using required rate of return as discount rate, and the decision is based on the present value of future returns.

2. Consideration Of Risk
Wealth maximization objective also considers the risks associated to the streams of future cash flows. The risk is taken care of by using appropriate required rate of return to discount the future streams of cash flows. Higher the risk, higher will be the required rate of return and vice versa.

3.Efficient Allocation Of Resources
Shareholders wealth maximization objective provides guideline for firm's decision making and also promotes an efficient allocation of resources in the economic system. Resources are generally allocated taking into consideration the expected return and risk associated to a course of action. The market value of stock itself reflects the risk return trade-off associated to any investor in the capital market. In other words, shareholder wealth , maximization considers the riskiness of the income stream. Therefore, if a firm makes financing decisions considering market price of share maximization, it will raise necessary capital only when the investment ensures the economic use of capital. In the absence of pursuing the goal of shareholders wealth maximization, there is danger of sub-optimal allocation of resources in an economy that leads to inadequate capital formation and low rate of economic growth.

4. Residual Owners
Shareholders are residual claimants in earnings and assets of the company. Therefore, if shareholders wealth is maximized, then all others with prior claim than shareholders could be satisfied.

5. Emphasis On Cash Flow
Wealth maximization objective uses cash flows rather than accounting profit as the basic input for decision making. The use of cash flows is less ambiguous because it represents means profit after tax plus non-cash outlays to all.

Course Outcomes		PO1	PO2	PO3	PO4	PO5	PO6	PO7	PO8	PO9	PO10	PO11	PO12
CO1:	To explain the basic functions and responsibility of a financial	1a. b,	2b										

	department in a business.	3a											
C02:	To elaborate the key decision areas in Financial Management investment , financing, dividend and working capital management.		3c, 2a	6									
CO3:	To explain the various techniques of evaluation of investment proposal												
CO4:	To discuss the various factors to be considered in designing the target capital structure.												
CO5:													
CO6:													

Cognitive level	KEYWORDS
L1	List, define, tell, describe, identify, show, label, collect, examine, tabulate, quote, name, who, when, where, etc.
L2	summarize, describe, interpret, contrast, predict, associate, distinguish, estimate, differentiate, discuss, extend
L3	Apply, demonstrate, calculate, complete, illustrate, show, solve, examine, modify, relate, change, classify, experiment, discover.
L4	Analyze, separate, order, explain, connect, classify, arrange, divide, compare, select, explain, infer.
L5	Assess, decide, rank, grade, test, measure, recommend, convince, select, judge, explain, discriminate, support, conclude, compare, summarize.

PO1 - *Engineering knowledge*; PO2 - *Problem analysis*; PO3 - *Design/development of solutions*; PO4 - *Conduct investigations of complex problems*; PO5 - *Modern tool usage*; PO6 - *The Engineer and society*; PO7- *Environment and sustainability*; PO8 – *Ethics*; PO9 - *Individual and team work*; PO10 - *Communication*; PO11 - *Project management and finance*; PO12 - *Life-long learning*